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C O N F I D E N T I A L SECTION 01 OF 04 ZAGREB 000491

SIPDIS

TREASURY FOR VIMAL ATUKORALA
STATE PASS USAID E&E
ROME FOR MAUREEN GREWE

E.O. 12958: DECL: 02/13/2013

TAGS: [ECON](#) [EFIN](#) [EAID](#) [EAGR](#) [EFIN](#) [EAID](#) [EAGR](#) [EFIN](#) [EAID](#) [EAGR](#) [HR](#) [HRECON](#)

SUBJECT: CROATIAN PRIVATIZATION HITS ROADBLOCK;
IMPLICATIONS FOR IMF, WORLD BANK PROGRAMS

REF: A. ZAGREB 199 (NOTAL)

[B](#). ZAGREB 326 (NOTAL)
[C](#). 02 ZAGREB 3045

CLASSIFIED BY: ECONOMIC OFFICER ISABELLA DETWILER, REASONS 1.5 (B AND D
)

SUMMARY

[1](#)1. (SBU) THE POLITICAL CONFLICT OVER THE ABORTED
PRIVATIZATION OF THE SUNCANI HVAR HOTEL GROUP, REPORTED REFS
A AND B, IS HAMPERING PROGRESS ON THE REST OF THE PORTFOLIO
OF THE CROATIAN PRIVATIZATION FUND (CPF) AND MORE GENERALLY
ON CROATIA'S WHOLE ECONOMIC REFORM PROGRAM. THE ANIMUS
TOWARD PRIVATIZATION THAT CONTRIBUTED IN PART TO THE SUNCANI
HVAR CRISIS, TOGETHER WITH UNREALISTIC EXPECTATIONS, IS ALSO
CASTING DOUBT ON THE VIABILITY OF THE PARTIAL PRIVATIZATION
OF 25 PERCENT PLUS ONE SHARE OF THE STATE OIL COMPANY, INA.
WITH PRIVATIZATION RECEIPTS DOWN, THIS COULD RAISE SERIOUS
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CONCERNS ABOUT CROATIA'S ABILITY TO FULFILL THE CONDITIONS OF
ITS PRECAUTIONARY STAND-BY ARRANGEMENT (REF C). ALSO IN
DOUBT IS THE GOC'S ABILITY TO SATISFY WORLD BANK CONDITIONS
FOR ITS STRUCTURAL ADJUSTMENT LOAN. END SUMMARY.

SUNCANI HVAR EPISODE CASTING LONG SHADOW

[1](#)2. (C) WHILE RUMORS THAT PERSONAL INTEREST ON THE PART OF
PROMINENT HSS (CROATIAN PEASANTS PARTY) MEMBERS PLAYED A KEY
ROLE IN THE CANCELLATION OF THE INTERNATIONAL TENDER FOR
SUNCANI HVAR ARE INTRIGUING, THERE IS NO DOUBT THAT GENERAL
SUSPICION OF PRIVATIZATION IN THE RULING COALITION --
PARTICULARLY IN THE HSS -- ALSO PLAYED A ROLE. HNS (CROATIAN
PEOPLES' PARTY) PRESIDENT, VESNA PUSIC, TOLD THE AMBASSADOR
ON FEBRUARY 25 THAT, WHILE THERE WERE ERRORS IN THE
PREPARATION OF DECISION DOCUMENTS FOR THE SUNCANI HVAR
TENDER, THEY DID NOT MERIT LEVEL OF REACTION THE SALE
RECEIVED.

[1](#)3. (C) WHILE MOST OF OUR GOC CONTACTS AT THE WORKING LEVEL
IN THE PRIME MINISTER'S OFFICE AND THE MINISTRIES OF TOURISM,
ECONOMY AND FINANCE UNDERSTAND THE NECESSITY OF ATTRACTING
FOREIGN INVESTMENT, WORLD-CLASS TECHNOLOGY AND MARKETING
KNOW-HOW IN TOURISM, THE GENERAL PUBLIC THINKS THAT
PRIVATIZATION OFTEN EQUALS CORRUPTION AND THAT, IF
PRIVATIZATION MUST OCCUR, CROATIANS SHOULD BE GIVEN
PREFERENCE IN ANY TENDERS. SALES OF COASTAL ASSETS ARE
PARTICULARLY CONTROVERSIAL. AND SALES TO SLOVENIANS -- ABOUT
WHOM CROATS HAVE A SIZABLE CHIP ON THEIR COLLECTIVE SHOULDER
-- ARE PARTICULARLY DIFFICULT TO ACCEPT.
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[1](#)4. (U) A COMMISSION OF THREE MINISTERS WAS TECHNICALLY
APPOINTED TO "REVIEW" THE TENDER FOR THE SALE OF SUNCANI
HVAR. WHEN A WEEK LATER THE COMMISSION ANNOUNCED THE
CANCELLATION OF THE SALE, NO ONE WAS SURPRISED. THE OFFICIAL
RESOLUTION ON THE CANCELLATION CONTAINED NO EXPLANATION OF
WHY THE INTERNATIONAL TENDER WAS CANCELLED, BUT CITED SIMPLY
"OMISSIONS" OR "FAILURES." IN A POLITICAL FLOURISH, THE
STATEMENT, SIGNED BY THE PRIME MINISTER, DISSOLVED THE
SUPERVISORY BOARD OF THE PRIVATIZATION FUND AND RELIEVED OF
THEIR DUTIES DEPUTY PRIME MINISTER SLAVKO LINIC, SDP (RULING
SOCIAL DEMOCRAT) STALWART AND PRIME PROMOTER OF
PRIVATIZATION, MINISTER OF AGRICULTURE BOZIDAR PANKRETIC
(HSS), MINISTER OF TOURISM PAVE ZUPAN RUSKOVIC
(NON-PARTISAN), MINISTER OF FINANCE CRKVENAC (SDP) AND
MINISTER OF ECONOMY JURCIC (NON-PARTISAN).

[1](#)5. (SBU) THE HOLLOWNESS OF THIS GESTURE IS BETRAYED BY THE
FACT THAT THE LAST PARAGRAPH OF THE RESOLUTION TASKS THE
MINISTRY OF ECONOMY -- WHOSE HEAD WAS JUST RELIEVED OF HIS
DUTIES ON THE SUPERVISORY BOARD BECAUSE OF "OMISSIONS" -- TO
DRAW UP A NEW LAW REFORMING THE PRIVATIZATION FUND.

16. (SBU) SINCE THE "OMISSIONS" WERE CONVENIENTLY NEVER

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	EB-00	EXIM-01	E-00	FAAE-00	FBIE-00	VC-00	FRB-00
	H-01	TEDE-00	INR-00	ITC-01	JUSE-00	LAB-01	L-00
	VCE-00	MOFM-05	MOF-01	AC-01	NSAE-00	NSCE-00	OMB-01
	OPIC-01	ACE-00	P-00	SP-00	SSO-00	STR-00	USIE-00
	EPAE-00	PRM-00	DRL-01	G-00	NFAT-00	SAS-00	SWCI-00
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R 070931Z MAR 03
FM AMEMBASSY ZAGREB
TO SECSTATE WASHDC 9615
DEPT OF TREASURY WASHDC
INFO AMEMBASSY ATHENS
AMEMBASSY BELGRADE
AMEMBASSY BRATISLAVA
AMEMBASSY BUCHAREST
AMEMBASSY BUDAPEST
AMEMBASSY LJUBLJANA
AMEMBASSY ROME
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DEFINED, IT IS IMPOSSIBLE TO SAY WHETHER THE RESULTING PROPOSAL FOR "REFORMING" THE CPF ADDRESSES THEM. THE CURRENT PROPOSAL CIRCULATING EXPANDS THE SCOPE OF THE CPF'S MANDATE TO INCLUDE DISPOSAL OF STATE-OWNED REAL ESTATE AND TO BECOME SOMETHING OF AN INVESTMENT AND EXPORT PROMOTION AGENCY. THE PLAN APPEARS TO BE A HASTILY DUSTED-OFF VERSION OF ONE ORIGINALLY DEVELOPED UNDER EX-PRESIDENT OF THE PRIVATIZATION FUND AND LATER MINISTER OF ECONOMY, HRVOJE VOJKOVIC. WHILE WE HAVE NOT FULLY EVALUATED THE PLAN, ONE IMMEDIATELY EVIDENT FLAW IS THAT IT DUPLICATES FUNCTIONS OF EXISTING AGENCIES, ESPECIALLY THE NEWLY-CREATED AGENCY FOR EXPORT AND INVESTMENT PROMOTION. THE NEW PLAN WILL REQUIRE CONSIDERABLE PERSONNEL AND FINANCIAL RESOURCES AND TAKE SOME TIME TO GET UP AND RUNNING.

17. (SBU) IN THE MEANTIME, WITHOUT A SUPERVISORY BOARD THE CPF CANNOT APPROVE NEW TENDERS. IT CAN CARRY OUT SOME ROUTINE BUSINESS, SUCH AS SELLING ON THE STOCK EXCHANGES PACKAGES OF MINORITY SHARES (USUALLY BOUGHT BY THE MAJORITY SHAREHOLDERS), AND DOING THE PREPARATORY WORK FOR THE
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TENDERING OF COMPANIES, MUCH OF IT WITH THE HELP OF USAID CONTRACTORS. THE GOVERNMENT IS CASTING ABOUT TO FIND SOME WAY TO CONTINUE WITH THE MOST PRESSING ITEMS IN THE PRIVATIZATION PORTFOLIO -- INCLUDING SELLING OFF A NUMBER OF STATE AGRICULTURAL COMPANIES (AGROKOMBINATS) THAT ARE BASICALLY BANKRUPT. THE STATE DOES NOT EXPECT TO EARN MUCH REVENUE FROM THE SALE OF THESE COMPANIES, BUT DOES HOPE THAT THE AGROKOMBINATS WILL, IN AT LEAST SOME CASES, RECEIVE DESPERATELY NEEDED INJECTIONS OF CAPITAL AND MANAGEMENT KNOW-HOW.

18. (SBU) IF THESE COMPANIES ARE FORCED TO SHUT DOWN, THOUSANDS OF RURAL WORKERS COULD BE LEFT WITHOUT JOBS -- HARDLY A DESIRABLE RESULT FOR THE RURAL-BASED HSS. IN AT LEAST ONE CASE, THERE ARE ATTRACTIVE DOMESTIC BIDDERS WAITING IN THE WINGS; IN ANOTHER A MANAGEMENT-EMPLOYEE BUYOUT WAS IN THE WORKS. THERE WAS SOME DISCUSSION OF HAVING THE CABINET APPROVE THESE TENDERS DIRECTLY. THE IDEA CURRENTLY BEING FLOATED IS TO APPOINT AN INTERIM BOARD TO APPROVE A LIMITED NUMBER OF PRIORITY TENDERS. ONE THING IS CLEAR -- ONLY TENDERS WITHOUT A WHIFF OF CONTROVERSY COULD BE APPROVED.

HEADACHES FOR THE WORLD BANK

19. (SBU) IF THE AGROKOMBINATS ARE NOT PRIVATIZED, THERE WILL BE ENORMOUS PRESSURE FOR THE GOVERNMENT TO INCREASE SUBSIDIES. IN WHAT IS AN ELECTION YEAR, THE GOVERNMENT MAY CAVE. THIS WOULD PUT PRESSURE ON THE GOVERNMENT'S BUDGET, PUSHING IT ABOVE ITS FIVE PERCENT OF GDP DEFICIT TARGET -- THEREBY IMPERILING CROATIA'S STANDBY ARRANGEMENT WITH THE IMF

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AND THE DISBURSEMENT OF THE SECOND TRANCHE OF THE WORLD BANK'S STRUCTURAL ADJUSTMENT LOAN. WORLD BANK SOURCES HERE SUSPECT THAT THE GOVERNMENT MIGHT MISS ITS SUBSIDY REDUCTION TARGET, BUT TOLD US THEY HOPE FOR A STRONG SHOWING ON THE GOC'S OTHER PRIOR ACTIONS. THIS IS FAR FROM CERTAIN, AS THE UNIONS GEAR UP TO OPPOSE THE DRAFT CHANGES TO THE LABOR LAW, WHICH AS SUBMITTED TO THE PARLIAMENT, ONLY MINIMALLY MEETS WORLD BANK CONDITIONS.

CONCERNS ABOUT "THE BIG ONE"

110. (C) MEANWHILE, PRIVATIZATION PROBLEMS CAST A BIG CLOUD OVER INA, THE STATE PETROLEUM COMPANY, 25 PERCENT OF WHICH THE GOC WOULD LIKE TO SELL OFF. WHILE THE INA PRIVATIZATION DOES NOT FALL UNDER THE PRIVATIZATION FUND, IT IS AT LEAST AS POLITICAL AS THE "NON-STRATEGIC" PRIVATIZATIONS. THE GOVERNMENT IS KEEPING A TIGHT LID ON INFORMATION ABOUT THE BIDS, BUT THE RUMORS ARE NOT GOOD. WE INITIALLY HEARD THAT THE RUSSIAN BID WAS THE BEST OF A BAD LOT, BUT WOULD REQUIRE THE SHUTTING DOWN OF THE REFINERY IN SISAK (A DEATH KNEEL FOR THIS TOWN ALREADY STRUGGLING UNDER THE CLOSURE OF ITS OBSOLETE STEEL MILL), AND DANGEROUS POLITICALLY. THE RUSSIAN BID WOULD ALSO REQUIRE THAT INA PUT UP AN EVEN GREATER AMOUNT

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	OPIC-01	ACE-00	P-00	SP-00	SSO-00	STR-00	USIE-00
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OF CAPITAL INVESTMENT. AND THE OTHER BIDS WERE DESCRIBED AS EVEN MORE PROBLEMATIC. HOWEVER, THE GOVERNMENT IS NEGOTIATING INTENSELY WITH AUSTRIA'S OMV, AND HAS YET TO BEGIN NEGOTIATIONS WITH HUNGARY'S MOL. LATELY, THE SPIN-DOCTORS HAVE BEEN LEAKING THAT THE OMV BID IS THE FAVORED ONE.

111. (SBU) UNFORTUNATELY, THE GOC HAS PROBABLY DONE A BETTER

JOB CONVINCING THE CROATIAN PUBLIC THAN THE BIDDERS THAT INA IS A CROWN JEWEL -- CLEANING UP ITS BOOKS BY WRITING OFF DEBT, TRUMPETING THE "RETURN TO PROFITABILITY" OF A COMPANY THAT IS SLOWLY DETERIORATING -- AND THE RESULT WILL BE THAT ANY RATIONAL OFFER WILL PROBABLY BE ATTACKED AS SELLING OFF CROATIA'S PATRIMONY FOR A SONG. IN THE CURRENT POLITICAL CLIMATE, THERE WILL NEED TO BE NEAR-UNANIMITY ON THE TENDER DECISION. WE HAVE SEEN THIS MOVIE BEFORE -- LAST YEAR THE GOVERNMENT'S UNREALISTIC EXPECTATIONS CONCERNING THE PRICE TAG FOR STATE-OWNED INSURER CROATIA OSIGURANJE SCARED AWAY INVESTORS, INCLUDING ALLIANZ.

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112. (SBU) FINDING A STRATEGIC PARTNER IS ESSENTIAL FOR INA; WITHOUT AN INJECTION OF CAPITAL, ITS REFINERIES WILL FALL FURTHER AND FURTHER BEHIND. IN A FEW YEARS, IT WILL BE UNABLE TO EXPORT TO WESTERN EUROPE BECAUSE IT WILL NOT MEET EU QUALITY STANDARDS. INA ALSO NEEDS THE MARKETING LINKS THAT A GOOD PARTNER WOULD BRING. NEVERTHELESS, THE GOVERNMENT, WITH THE CONNIVANCE OF THE MANAGEMENT OF INA, IS PUTTING CONDITIONS ON THE SALE -- SUCH AS RETENTION OF ALL EMPLOYEES FOR THREE YEARS -- THAT MAKE THIS PARTIAL SALE PROBLEMATIC.

113. (C) IF THE INA SALE DOES NOT GO THROUGH, THE GOC'S PROGRAM WITH THE IMF COULD BE IN TROUBLE. THE IMF LETTER OF INTENT (LOI) SETS A DEADLINE OF ANNOUNCING THE RESULTS OF THE TENDER BY THIS MONTH. UNLESS A SWEET DEAL IS NEGOTIATED, THE RESULT COULD BE THAT THE GOVERNMENT REJECTS ALL THE BIDS. THE LOI GOES ON TO SAY THAT IF PRIVATIZATION REVENUES (1.2 PERCENT OF GDP FOR THIS YEAR) FALL SHORT, THEN THE GOVERNMENT MUST CUT SPENDING, IN ORDER TO KEEP THE DEBT LOAD FROM RISING. WHEN WE ASKED THE IMF REPRESENTATIVE WHETHER HE THOUGHT THE GOC COULD MAKE ITS REVENUE TARGETS WITHOUT A SUCCESSFUL INA PRIVATIZATION, HE THOUGHT IT UNLIKELY. ADDITIONALLY, EVEN IF THERE ARE HIGHER THAN PROJECTED TAX REVENUES, THINGS ARE NOT LOOKING TOO GOOD ON THE EXPENDITURE FRONT, SINCE THE GOC'S DOWNSIZING OF THE MINISTRY OF DEFENSE IS BEHIND SCHEDULE AS WELL.

A SILVER LINING

114. (SBU) A YEAR AND A HALF AGO, WHEN THE USG OFFERED
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ASSISTANCE TO THE GOC FOR PUBLIC EDUCATION OF THE PRIVATIZATION PROCESS, THE GOVERNMENT WAS RESISTANT. A LOW-KEY CAMPAIGN BEGAN WITH ONLY THE SUPPORT OF THE DEPUTY PRIME MINISTER'S OFFICE AND THE PRESIDENT OF THE CPF. WHILE PUBLIC OPINION POLLS SHOW LITTLE CHANGE IN ATTITUDES BY A PUBLIC REFLEXIVELY OPPOSED TO PRIVATIZATION -- DECADES OF SOCIALISM UNDER TITO AND YEARS OF CRONY CAPITALISM UNDER TUDJMAN HAVE TAKEN THEIR TOLL -- ENTHUSIASM FOR THE EDUCATION PROCESS SPREAD AMONG OTHER PARTIES OF THE RULING COALITION, AND THE GOC EXPANDED THE PUBLIC EDUCATION CAMPAIGN WITH ITS OWN FINANCIAL RESOURCES. JOURNALISTS INCLUDED IN THE EDUCATIONAL PROCESS WERE EXPOSED TO PRIVATIZATION-REPORTING JOURNALISTS IN NEIGHBORING HUNGARY, AND ON THE SUNCANI HVAR STORY, THEY DEMONSTRATED THE MOST BALANCED REPORTING IN THE HISTORY OF CROATIAN PRIVATIZATION.

COMMENT

115. (C) THE TWO MAIN COALITION PARTIES NEARLY DISSOLVED THE GOVERNMENT AND SOUGHT EARLY ELECTIONS OVER SUNCANI HVAR. WHILE WE KNOW THAT THE SDP AND HSS BURIED THE HATCHET TO AVOID EARLY ELECTIONS, THE LACK OF PUBLIC DEBATE OVER THE MERITS OF WHAT BROUGHT DOWN THE CROATIAN PRIVATIZATION FUND

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HAS ADDED EVEN MORE DOUBT TO THOSE MISTRUSTFUL OF ANY SORT OF
PRIVATIZATION. THIS IS A GOVERNMENT WITH MANY SOCIALIST-ERA
DINOSAURS, INCLUDING AT TIMES THE PRIME MINISTER, WHO ARE NOT
FIRMLY CONVINCED OF THE NECESSITY OF MARKET-ORIENTED REFORMS.
THUS WHEN PUSH-COMES-TO-SHOVE, SHORT-TERM POLITICAL
CONSIDERATIONS EASILY TRUMP ECONOMIC REFORM. IT APPEARS
THAT, IN WHAT IS A PRE-ELECTION PERIOD, ANY PRIVATIZATION
THAT COULD RESULT IN LAYOFFS, INVOLVE FOREIGN OWNERSHIP, OR
EVEN WHICH COULD BE SEEN AS PROVIDING COMPETITION TO DOMESTIC
FIRMS, WILL COME UNDER ATTACK. ELECTION YEAR CALCULATIONS
WILL PROBABLY LEAD TO VERY MARGINAL PROGRESS ON
PRIVATIZATION, MOUNTING DEBT, AND LOST TIME ON ECONOMIC
REFORM.
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